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SUBJECT: LATVIAN ECONOMY STRUGGLING TO ADJUST

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¶1. Summary: Significant internal economic instability, combined with the adverse international financial climate, has hit the Latvian economy hard. Nearly every macroeconomic indicator is showing declining economic activity. The GOL is taking steps to help the economy adjust and recover, but economic activity has been slow to respond, as business and consumer confidence is low. The government is struggling to adopt a budget that reflects economic reality, given the political cost of an austere budget, and the bank of Latvia charges that the government should push for a fully balanced budget. On a more positive note, the Nordic banks that are dominant in Latvia and crucial to the country's economy are stable for the moment, providing some sense of security to Latvia's economic outlook. End summary.

¶2. At the end of 2007, Latvian economic growth cooled, as quarterly GDP growth rates slowly began to fall. Some degree of economic slowdown was much welcomed and anticipated, since the previous period of double-digit growth was beginning to overheat the economy and create various economic abnormalities. Price inflation was setting new records each month and the current account deficit had reached unprecedented levels, hitting 26.9% of GDP in the second quarter of 2007. The cooling of the economy became more evident when the first quarter 2008 growth rate fell sharply to 3.3%. The 2008 second quarter GDP growth, which fell to 0.1% annualized, confirmed that the Latvian economy was almost certainly headed for a recession.

¶3. As part of the government's previous anti-inflation plan, the Cabinet in 2007 mandated financial institutions to evaluate the soundness of borrowers' finances more closely, in order to slow lending. In response to the slowing economy and changes in macroeconomic policy priorities, some of these mandated measures have since been lifted. However, financial institutions have voluntarily continued the increased scrutiny of borrowers. This scrutiny has decreased credit availability for consumers, and since much of the previous growth was based on credit-financed consumption, the measures are having a negative effect on domestic demand. Continued high inflation, which has hurt consumers' real disposable income, is shrinking domestic demand even further. The contraction of demand is reflected in retail sales which in August experienced the largest drop in the EU - 8.9%, and in the import rate which has been decreasing for several consecutive months, reaching negative 11.1% in August.

¶4. While Latvia still registers the highest inflation in Europe (14.9% year-on-year in September), it is showing a downward trend since inflation peaked at 17.9% y-o-y in May of this year. This downward tendency should persist, especially since Latvia's inflation shows a large share of country-specific inflation which implies domestic causes. One of these causes was, and to certain extent still is, an overheated labor market. The weakening activity in almost all sectors of the economy and increasing competition in the labor market should give ground for disinflation. A few jumps are nevertheless expected in the upcoming months due to higher energy and heating tariffs that will be going into effect. Disinflation might come at the cost of unemployment. By Latvian

standards, the registered unemployment rate is still quite low at 5.3%, but it has persistently been gaining a tenth of a percentage point each month since May and several economists are forecasting that it could reach 10% before the economy recovers.

¶5. Two items are showing signs of improvement. With imports falling, Latvia's negative trade balance is narrowing, which is helping to close the current account gap. The trade deficit has been decreasing since mid-2007 and this has pushed the current account deficit down to 15.6% of GDP in the second quarter of 2008.

¶6. Latvian export growth remains positive, but the rate of growth has been declining and may turn negative as productivity and cost issues mount. With global demand contracting and business confidence being low, companies are finding it increasingly difficult to find markets for their goods and services, and are cutting back on production or going out of business altogether. This has been particularly true in Latvia's wood-products sector, with IKEA furniture closing its Latvian wood plate plant and the Danish wood products company Pondus closing its production operations in Latvia. Industrial output has been falling for four consecutive months, reaching negative 11.1% in August, which was the steepest drop in the EU. Many businesses are evidently on the brink, as 23% more insolvency proceedings have been initiated in the first nine months of this year than for the same period last year. The Ministry of Economy has adopted additional measures aimed at helping prevent businesses from going bankrupt, including extending tax payment deadlines, waiving tax fees and penalties, as well as lifting taxes on reinvested profit.

¶7. Next year's central government budget proposal, which the Cabinet of Ministers has now submitted to the parliament for review, has

dominated the headlines in Latvian media in recent weeks. The Cabinet has been struggling to prepare a budget with a target deficit rate of 1.85% of GDP by reducing ministry spending, eliminating staff positions, postponing planned wage increases for public sector employees, and even proposing measures as drastic as closing specific ministries and switching to open source software. Labor unions and other affected parties have met these proposals with strong condemnation.

¶8. As tax revenues fall and economic growth approaches zero, preparing a fiscally-restrained, economically responsible budget is proving to be an extremely difficult task for the government. Freezes on public sector wages and reductions in other areas of funding are politically unpopular. As the ruling coalition has attempted to negotiate agreement on its budget proposal, the Bank of Latvia has been advocating for reducing government spending even further and calling for the adoption of a balanced budget, claiming that a deficit would drain the banking sector, increase interest rates and distort proper allocation of financial resources. The rating agency Fitch also appears to be concerned about Latvia's finances, more specifically, about its ability to finance its large current account deficit. As a result, the agency downgraded specific Latvian currency ratings and placed negative outlooks on those items.

¶9. In the midst of such economic turbulence, it is indeed fortunate that the Swedish banks which dominate the local financial market, Swedbank and SEB, appear healthy and Latvia's banking sector remains stable (reftel). This stability at least makes Latvia unlikely in the short term to experience the type of financial collapse seen in Iceland.

Larson